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Acronyms

DCI	Data Collection Instrument
e-Tims	Electronic Tooling Information Management System
NAVAIR	Naval Air Systems Command
OM&S	Operating Material & Supplies
PP&E	Property, Plant, and Equipment
RRAM	Real-time Reutilization Asset Management System
SFFAS	Statement of Federal Financial Accounting Standards
SOM	Sponsor Owned Material



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

April 23, 2007

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
COMMANDER, NAVAL AIR SYSTEMS COMMAND
NAVAL INSPECTOR GENERAL

SUBJECT: Reporting of Navy Sponsor Owned Material Stored at the Naval Air Systems
Command Activities (Report No. D-2007-085)

We are providing this report for information and use. We considered management
comments on a draft of this report when preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive
7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr.
James L. Kornides at (614) 751-1400, extension 211 or Mr. John K. Issel at (614) 751-1400,
extension 212. See Appendix B for the report distribution. The team members are listed inside
the back cover.

By direction of the Deputy Inspector General for Auditing:

Paul J. Granetto, CPA
Assistant Inspector General and Director
Defense Financial Auditing Service

Department of Defense Office of Inspector General

Report No. D-2007-085

(Project No. D2006-D000FJ-0130.001)

April 23, 2007

Reporting of Navy Sponsor Owned Material Stored at the Naval Air Systems Command Activities

Executive Summary

Who Should Read This Report and Why? Navy personnel responsible for reporting the amount and value of Sponsor Owned Material stored at Navy facilities should read this report. It discusses the financial reporting and control of Sponsor Owned Material stored by Naval Air Systems Command activities.

Background. The Department of the Navy reported \$58.8 billion of Operating Materials and Supplies on its first quarter FY 2006 financial statements. This included a sub-category of supplies and materials termed Sponsor Owned Material. The Navy defines Sponsor Owned Material as material needed to support program manager mission requirements. The material is used for item fabrication, assembly, testing, manufacture, repair, or research and development. For the fourth quarter FY 2006, the Naval Air Systems Command reported \$4.67 billion of Sponsor Owned Material.

Results. The Naval Air Systems Command did not accurately report the Sponsor Owned Material it included in the Navy's FY 2006 Financial Statements. The Navy misclassified the material and overstated its reported value at the four locations we visited. More than \$2.5 billion of Sponsor Owned Material was improperly classified and reported as Operating Materials and Supplies, including \$1.9 billion of special tooling and test equipment, \$481.6 million of aviation support equipment held for Foreign Military Sales, and \$113.7 million of general support equipment. Those items should have been reported in either the Navy Inventory or Property, Plant, and Equipment accounts.

Additionally, the Naval Air Systems Command did not maintain audit trails or adequately validate the data gathered about its Sponsor Owned Material before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in the financial statements. Therefore, the Naval Air Systems Command overstated the Sponsor Owned Material inventory by more than \$1.5 billion. Also, the Naval Air Systems Command did not always follow physical control procedures for managing materials, including performing required receipt, storage, and issue functions. Our review of 199 judgmentally selected items, valued at \$616.4 million, disclosed quantity errors in 45 items. The total value of the errors was \$443.2 million.

Overall, the audit showed that the value of Operating Materials and Supplies reported on the Navy Financial Statements was overstated by at least \$4 billion. We identified internal control weaknesses in the financial reporting and inventory management of Sponsor Owned Material. The Navy Air Systems Command needed to ensure its financial reporting of Sponsor Owned Material complied with Federal Financial Accounting Standards No. 3 and 6. Also, it needed to perform a complete reconciliation of its Sponsor Owned Material inventory amounts recorded in the Real-time Reutilization Asset Management System with the actual amounts of on-hand inventory. Lastly, Naval

Air Systems Command activities must ensure that audit trails were maintained and supporting documentation available for all data recorded in accounting systems and used in financial reports.

Unless the Naval Air Systems Command properly reports its Sponsor Owned Material and improves its inventory controls, future Navy financial statements will be unreliable and not in compliance with generally accepted accounting principles. In addition, the Navy will continue to be at high risk for loss of materials.

Management Comments. Comments from the Assistant Secretary of the Navy (Financial Management and Comptroller) were responsive. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred with all recommendations. Therefore, no further comments are required.

See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

The Department of the Navy reported \$58.8 billion of Operating Materials and Supplies on its first quarter FY 2006 financial statements. This included a sub-category of supplies and materials termed Sponsor Owned Material. Navy Sponsor Owned Material (SOM) consists of material that program managers purchase to support a program's lifecycle mission requirements. The Naval Air Systems Command (NAVAIR) stores SOM at 15 locations. The locations include Port Hueneme, California; Point Mugu, California; Barstow, California; China Lake, California; North Island, California; El Centro, California; Patuxent River, Maryland; Jacksonville, Florida; Lakehurst, New Jersey; Beaufort, South Carolina; Cherry Point, North Carolina; Norfolk, Virginia; Granite City, Illinois; Tucson, Arizona; and Cheatham, Virginia. It also manages SOM issued and in use at DoD contractor facilities world-wide.

The Navy defines SOM as "material required in support of program managers' mission requirements for production, life cycle maintenance, and installation of systems and equipment consistent with the mission charter. The material usage may involve, but is not limited to: item fabrication, assembly, testing, manufacture, repair, or research and development."

NAVAIR Centers perform research, development, test and evaluation, logistics, and maintenance functions, and provide industrial base and fleet support. The work performed by the Centers is in support of sponsor (primarily Program Executive Office or Program Management Office) requirements. Examples of NAVAIR sponsor programs include those that support the Navy's A-4, A-7, AV-8B, H-53, H-60, EA-6B, P-3, F-14, and F-18 aircraft.

Naval commands report the value of SOM on the financial statements through a Navy web-based system called the Data Collection Instrument (DCI). DCI users at the reporting level enter information each quarter. This information is consolidated at the command level and forwarded to the Assistant Secretary of Navy (Financial Management and Comptroller) who consolidates and provides the information to the Defense Finance and Accounting Service for inclusion in the Navy's financial statements. SOM is reported as an asset on the Navy General Funds Balance Sheet and is included as part of Operating Materials and Supplies (OM&S). In the fourth quarter of FY 2006, NAVAIR reported \$4.67 billion in SOM as OM&S held for use.

Objectives

Our audit objective was to evaluate the controls over Sponsor Owned Materials stored at NAVAIR locations. Specifically, we evaluated the physical inventory control and financial reporting of material reported as SOM. We also reviewed internal controls as they related to the audit objective. See Appendix A for a discussion of the scope and methodology.

Review of Internal Controls

We identified internal control weaknesses for NAVAIR as defined by DoD Instruction 5010.40, “Managers Internal Control (MIC) Program Procedures,” January 4, 2006. NAVAIR did not have adequate internal controls over the financial reporting and inventory management of SOM. Implementing Recommendations 1, 2, 3, and 4 will improve the overall financial and inventory management controls. A copy of the report will be provided to the senior official responsible for internal control in NAVAIR.

Financial Reporting and Controls Over Sponsor Owned Material

NAVAIR incorrectly reported about \$2.5 billion of SOM as OM&S. This included \$1.9 billion of aviation special tooling and test equipment, \$481.6 million of aviation support equipment held for Foreign Military Sales, and \$113.7 million of general aviation support equipment. Those items should have been reported in the Inventory or Property, Plant, and Equipment accounts. Additionally, the Naval Air Systems Command did not adequately validate the data gathered for Sponsor Owned Material before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in the financial statements which led to an overstatement of the inventory by over \$1.5 billion. We also found errors related to inventory control. Our review of 199 judgmentally selected sample items, valued at \$616.4 million, disclosed errors in the quantities on hand in 45 of the items we sampled. The value of the errors totaled \$443.2 million. Additionally, NAVAIR program managers did not always dispose of excess material and some assets were stored improperly. We attributed the conditions to the following control weaknesses:

- NAVAIR did not follow existing guidance and properly classify and report its assets in accordance with Federal accounting standards;
- NAVAIR personnel did not perform and document annual physical inventories or comply with established policy to require audit trails for the amounts that are reported in its financial statements; and
- NAVAIR personnel did not provide adequate oversight of contract work performed to modify the inventory updating and reporting process.

As a result of the conditions, the value of Operating Materials and Supplies reported on the Navy Financial Statements for FY 2006 was overstated by at least \$4 billion and the Navy risked undetected loss of items. Unless the Naval Air Systems Command properly reports its Sponsor Owned Material and improves its inventory controls, future Navy financial statements will be unreliable and not in compliance with generally accepted accounting principles and the Navy will continue to be at high risk for loss of materials.

Reporting SOM

We visited four of the Naval Air Systems Command locations that store SOM: Port Hueneme, California; Patuxent River, Maryland; Granite City, Illinois; and Jacksonville, Florida. We also reviewed data from the Navy's information management system on special tooling and test equipment. NAVAIR reported the information from locations worldwide.

Proper Reporting of NAVAIR SOM

NAVAIR reported the following SOM incorrectly:

Special Tooling and Test Equipment. NAVAIR improperly reported \$1.9 billion of SOM special tooling and test equipment assets as OM&S. The special tooling consisted of production tooling jigs, dies, fixtures, molds, patterns, taps, and gauges used by contractors to manufacture weapon systems. The test equipment included unique weapon system test benches and test sets used by NAVAIR activities and contractors to accomplish special purpose testing during the manufacture of weapon systems.

NAVAIR special tooling and test equipment assets were tracked in a non-financial feeder system, the Navy Electronic Tooling Information Management System (e-Tims). According to e-Tims records, NAVAIR's special tooling and test equipment were located at multiple locations that included:

- the Aerospace Maintenance and Regeneration Center, Tucson, Arizona, valued at \$75 million;
- a storage facility in England, valued at \$143 million;
- a storage facility in Granite City, Illinois, valued at \$378 million; and
- contractor facilities throughout the United States, valued at \$1.315 billion issued and in use.

NAVAIR's special tooling and test equipment held at these locations did not meet the Federal Accounting Standards Advisory Board standard for reporting as OM&S. Instead the assets met the definition of Property, Plant, and Equipment. According to the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," October 27, 1993, OM&S is tangible personal property to be consumed in normal operations. The standard requires that once an asset is issued to the end user, OM&S assets are expensed and removed from the balance sheet.

According to SFFAS No. 6, "Accounting for Property, Plant and Equipment" (PP&E), June 1996, PP&E is defined as "tangible assets that (1) have a useful life of 2 or more years, (2) are not intended for sale in the ordinary course of business, and (3) are intended to be used or available for use by the entity."

NAVAIR's special tooling and test equipment met the definition of SFFAS No. 6. The assets had a useful life of 2 years or more, were not going to be consumed in normal operations, and were issued and in use at contractor facilities. The special

tooling and test equipment assets should have been reported as part of the Navy's PP&E line on the Navy's balance sheet.

Equipment Held for Foreign Military Sales. NAVAIR improperly reported \$481.6 million of SOM aviation support equipment held in the Foreign Military Sales Reserve Program. The Foreign Military Sales Reserve Program included aviation support equipment consisting of material that was needed to provide initial outfitting and life cycle support for aircraft, systems, and equipment in support of foreign governments under the Security Assistance Program. Included in these balances were SOM from retired Navy aircraft programs including the A-4, A-7, and P-3 (models A and B) aircraft. Those aircraft were no longer part of the Navy's weapons system arsenal and were considered obsolete. Because these assets were not going to be consumed in normal Navy operations and were held for sale, they should have been reported as Foreign Military Sales inventory.

Aviation Equipment. NAVAIR included \$113.7 million of aviation support equipment items in its OM&S financial reports that did not meet the definition of OM&S. Included in the totals were aircraft refueling pods, test sets, communications modems, and a spectrum analyzer. Of the sample items selected for review at Patuxent River, Maryland, 31 items valued at \$9.1 million were over 15 years old and had been repeatedly used, repaired, and reissued for additional use. Of the 50 items, 6 were being used by the program office. The items did not meet the definition of OM&S because they had an expected life of 2 years or more and would not be consumed in operations. Also, the items that had been issued to the user should have been expensed and, as such, should not have been reported as OM&S.

Overstatement of NAVAIR SOM Inventory. NAVAIR personnel made a posting error when entering data into the fourth quarter FY 2006 DCI. NAVAIR personnel entered negative \$565 million in the issuances field on the DCI. The issuances field is a negative field and by erroneously entering a negative amount in the negative field the amount became positive. Instead of reducing on-hand SOM inventory by \$565 million, the on-hand inventory was increased by \$1.13 billion. This error occurred because NAVAIR personnel did not adequately validate the data gathered about its Sponsor Owned Material before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in the financial statements.

In addition to the posting error, NAVAIR duplicate reported SOM already reported through the Navy's e-Tims system. NAVAIR reported \$2.31 billion of SOM for the fourth quarter for Special Tooling and Test Equipment managed in the e-Tims system. The data showed that NAVAIR also duplicate reported \$379 million of material located at Granite City, Illinois. The reporting error occurred because NAVAIR Headquarters personnel believed that material stored

at Granite City was not included in the active e-Tims SOM totals. Information provided by the Navy Electronic Tooling System Program Manager showed that it was included in both SOM and e-Tims.

Existence of SOM

In addition to reporting deficiencies, NAVAIR inventory controls were not adequate to ensure the existence and complete accountability for all SOM assets.

Results of Sample

We visited four locations, (shown in Table 1) to verify the existence of assets classified as SOM. Our review of 199 judgmentally selected items, valued at \$616.4 million, disclosed quantity errors in 45 of the items, valued at \$443.2 million. Table 1 shows details on the number and value of errors by location.

Table 1. Sample Errors by Location

LOCATION	NUMBER OF ITEMS WITH DISCREPANCIES	VALUE OF DISCREPANCIES
PATUXENT RIVER, MD.	9	\$ 27,606,417
PORT HUENEME, CA.	34	414,863,103
GRANITE CITY, IL.	1	366,552
JACKSONVILLE, FL.	1	342,230
TOTAL	45	\$443,178,302

The primary reasons for the errors are the lack of compliance with policy, poor material inventory practices, and poor oversight of the contractor selected to upgrade the inventory process.

Materials Inventory Management. For 20 items in our sample, poor inventory management practices resulted in variances between the quantities on hand and the quantities recorded on inventory records. Table 2 shows the 20 items and the differences between the records and the physical count.

Table 2. Quantity Variances Caused by Weak Controls

SAMPLE NO.	ITEM	QUANTITY PER RECORD	ACTUAL PHYSICAL COUNT	VALUE NOT SUPPORTED
1	GC - 47 MOLD	1	0	\$ 366,552
2	JAX - 25 TEST SET RADAR	1	0	342,230
3	PH - 1 DRONE, AIRCRAFT	15	42	5,778,000
4	PH - 2 DRONE, AIRCRAFT	3	12	4,861,530
5	PH - 3 DRONE, AIRCRAFT	26	30	1,281,160
6	PH - 13 PUMP, ROTARY	14	13	14,102
7	PH - 15 ROTOR, TURBINE, AIRCRAFT GAS TURBINE	6	1	142,808
8	PH - 17 PUMP, ROTARY	18	3	118,523
9	PH - 18 AFT SUPPORT ASSEMBLY	24	25	5,766
10	PH - 28 CHAMBER, COMBUSTION, TURBINE ENGINE	4	2	34,432
11	PH - 29 POWER SUPPLY	3	2	22,893
12	PH - 43 NOZZLE ASSEMBLY, TURBINE, AIRCRAFT	4	0	47,901
13	PH - 44 PILOT CHUTE	47	50	3,057
14	PH - 45 POWER SUPPLY	13	12	3,679
15	PH - 47 VALVE, GATE	4	10	71,618
16	PR - 18 INDICATOR, DIGITAL DISPLAY	1	0	374,661
17	PR - 36 STORE ASSEMBLY, REFUELING	4	2	530,000
18	PR - 48 GYRO, LASER	1	9	1,454,336
19	PR - 49 GROUND CONTROL STATION, LAND BASED	1	0	350,000
20	PR - 50 GROUND CONTROL STATION, SHIPBOARD	1	0	325,000
				\$16,128,250

We attributed the discrepancies to NAVAIR program managers' lack of management over the stocks of materials. We found little evidence that the NAVAIR centers were using standard inventory practices, including documenting material receipt, storage, and issue. For example, at Port Hueneme quarterly inventories were performed and records maintained of the on-hand counts, but issue and receipt documentation was not maintained to establish an audit trail for the movement of the material. After the maintenance shop had determined that it was not economical to repair an item, any usable components or piece parts were stripped from the item and turned into the SOM warehouse. The maintenance shop did not maintain documentation to show what was shipped, and the warehouse did not record the receipt of this material. During the audit, Port Hueneme personnel began to establish the needed procedures to account for the movement of material.

Updated Information. NAVAIR and contractor personnel performed wall-to-wall inventories to locate, identify, and report SOM. NAVAIR reported the inventory data in the Navy's Real-time Reutilization Asset Management (RRAM) system. NAVAIR procedures require that the RRAM system be updated on a monthly basis to record changes to the inventory. NAVAIR did not follow the monthly update procedures. NAVAIR reported \$571.4 million of Class III SOM inventory in RRAM from March 2006 through September 2006 and that amount was reported by the Naval Supply Systems Command in their DCI submission in September of 2006.

To aid in the reporting process, the contractor, Stanley Associates, developed a Customer Inventory Record tool to create a Master RRAM Table to facilitate the electronic upload of inventory data to the RRAM system. However, in January 2006 while validating inventory, NAVAIR personnel noted discrepancies in Part Number, National Stock Number, Commercial and Government Entity Codes and Quantity fields. The contractor subsequently performed an analysis on Customer Inventory Record and determined that programming language errors and input errors caused the discrepancies. The contractor could not explain why the errors occurred.

For 25 items in our sample, the quantities on hand varied significantly from the quantities recorded on inventory records. To illustrate, 11 of the 50 items we selected for review were not on hand at Port Hueneme and there was no evidence they had been there. NAVAIR attributed the \$428.1 million in errors related to the 25 sample items in the SOM inventory database at Port Hueneme, California, and Patuxent River, Maryland, to the contractor errors. Table 3 shows the 25 items and the differences between the records and the physical count.

Table 3. Quantity Variances Caused by Contractor Errors and Weak Controls

SAMPLE		QUANTITY PER RECORD	ACTUAL PHYSICAL COUNT	VALUE NOT SUPPORTED
NO.	ITEM			
1	PR - 01	CONVERTER-CONTROLLER	8	1 \$ 1,524,880
2	PR - 02	MODEM, DATA CONTROL	8	2 1,216,380
3	PR - 33	CONVERTER-CONTROLLER	100	1 21,566,160
4	PR - 47	STORE ASSEMBLY, REFUELING	1	0 265,000
5	PH - 06	ENGINE, TURBO-JET*	225	122 25,126,953
6	PH - 07	CIRCUIT CARD ASSEMBLY	8000	0 325,352,000
7	PH - 08	CIRCUIT CARD ASSEMBLY	24000	0 45,768,000
8	PH - 09	CONVERTER, VOLTAGE	138	0 3,901,536
9	PH - 10	NACELLE	10	4 434,256
10	PH - 11	FUEL CONTROL, MAIN, TURBINE ENGINE	8	2 491,868
11	PH - 12	COMPUTER, FLIGHT DIRECTOR	6	0 212,064
12	PH - 16	ACTUATOR, ELECTRO-MECHANICAL, LINE	16	8 81,528
13	PH - 19	ARMING UNIT	22	2 103,800
14	PH - 20	REGULATOR ASSEMBLY, OIL	14	7 48,254
15	PH - 22	CABLE ASSEMBLY, SPECIAL PURPOSE	4	0 91,571
16	PH - 23	PARACHUTE, AIRCRAFT, DECELERATION	80	40 45,430
17	PH - 30	BAG, FLOTATION	120	68 29,203
18	PH - 31	CHARGER, BATTERY	13	0 67,210
19	PH - 32	CABLE ASSEMBLY, SPECIAL PURPOSE	14	0 64,400
20	PH - 35	COMPUTER, FLIGHT DIRECTOR	2	0 61,044
21	PH - 36	CIRCUIT BREAKER	4000	0 59,240
22	PH - 40	EXCITER, IGNITION	13	12 4,061
23	PH - 41	WING ADAPTER ASSEMBLY	4	1 38,208
24	PH - 42	CASE, COMPRESSOR, AIRCRAFT	3	0 49,254
25	PH - 46	CIRCUIT CARD ASSEMBLY	12	0 47,752
				\$426,650,052

Two of the largest errors in the sample related to circuit cards. The contractor updated the records and recorded 8000 circuit card assemblies (Part No. M22759/11-10-9) valued at \$325.3 million and 24,000 circuit card assemblies (Part No. M27500-20-TE-2T14) valued at \$45.7 million. We reviewed those items and concluded that during the Customer Inventory Record update process wire with a similar part number had been recorded as circuit cards. We found no evidence that either type of circuit card ever existed in the inventory. We concluded that the contractor-developed electronic upload process caused the errors.

We believe the significant coding errors could have been avoided if oversight by NAVAIR personnel had been better. NAVAIR personnel were not providing adequate reviews of contractor work performed as the contractor modified and

* Includes all J-85 Engines (Sample 6 [222] and Sample 5 [3]).

updated the inventory process. Furthermore, even though we notified NAVAIR of the significant data errors in June 2006, corrective action had not been taken as of October 2006. For example, RRAM data still showed that 225 J85-GE-100 turbo jet engines used on target drones were located at Port Hueneme. However, there were only 122 engines on hand. A review of prior inventory records showed that the number of jet engines in the inventory was never greater than 152. The difference of 103 engines valued at \$25.1 million was still reflected in data records, which continued to result in overstated assets in the Navy's financial statements. NAVAIR needed to take immediate action to review and correct the RRAM inventory data records at Port Hueneme.

In addition to the accountability issues, the assets for 6 of the 199 items we sampled (valued at \$3 million) were obsolete and should have been turned in to disposal. We asked personnel at Patuxent River about \$7.6 million of SOM assets (that were not part of our sample) stored in two CONEX containers behind a Program Office. They indicated that the material was so old they no longer knew its purpose.

We also observed that two of our sample items, valued at \$623.3 thousand, were stored in a CONEX storage shed at Patuxent River. The shed was not environmentally secure. It had standing water on the floor and the lighting in the shed was not adequate enough to read the stock numbers or part numbers on the material. The sample items in the shed were avionics equipment items (including converter controllers and data control modems) that should have been stored in more environmentally stable conditions.

This accountability, retention, and storage of SOM has been a long-standing problem. The last review of NAVAIR accountability over SOM was conducted by the Naval Audit Service during 1998. Naval Audit Service Report No. 037-98, "Management of Sponsor Owned Material at Naval Air Systems Command Warfare Centers," June 2, 1998, disclosed that the Centers had significant amounts of SOM that were not recorded and for which the value was indeterminable. Also, the report stated that the Centers were holding excess quantities of SOM and not making it available to other Navy and DoD activities, and that the NAVAIR Program Offices preferred to store material for possible future use rather than turning the material into the supply system or disposal for no credit. In response to the report findings, NAVAIR established a Total Asset Visibility Group and special inventory teams to improve the accountability of SOM assets and to conduct special inventories of SOM.

Conclusion

We concluded NAVAIR needed to follow Navy guidance on reporting of SOM. At present the guidance consists of NAVAIR Instruction 4451.2, "Management of Naval Air Systems Command Sponsor Owned Material," dated December 4, 2003. The instruction assigns responsibility and establishes policy for the control, management, and accountability of NAVAIR SOM. The goal of this policy is to:

- accurately record and report SOM inventory including financial reporting requirements;

- optimize reutilization and redistribution of SOM through Total Asset Visibility; and
- retain only needed levels of SOM to execute the NAVAIR mission.

NAVAIR program offices did not follow the Instruction. The Navy needs to dedicate resources to enforce the guidance to ensure compliance with financial reporting and material management practices. NAVAIR also needs to complete a review of SOM asset accountability at the NAVAIR locations as soon as possible. The poor controls adversely affected the overall integrity of the NAVAIR SOM inventory and could impede the capability to detect theft, fraud, or diversion of material.

Recommendations and Management Comments

We recommend that the Commander, NAVAIR:

1. Enforce Naval Air Systems Command (NAVAIR) Instruction 4451.2, “Management of Naval Air Systems Command Sponsor Owned Material,” December 4, 2003, to ensure that the financial reporting of Sponsor Owned Material complies with the Statement of Federal Financial Accounting Standards No. 3 and No. 6. Enforcement should include ensuring proper categorization of material as Operating Materials and Supplies; Inventory; or Property, Plant, and Equipment. Any changes should be coordinated with the Assistant Secretary of the Navy (Financial Management and Comptroller).

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred. The Assistant Secretary stated that the Naval Air Systems Command will enforce compliance with Instruction 4451.2 upon receiving revised guidance pertaining to the proper segregation of Sponsored Owned Material in categories that comply with the Statement of Federal Financial Accounting Standards No. 3 and No. 6. The Assistant Secretary also agreed to publish updated instructions for the Data Collection Instrument that will properly define the distinction between Operating Materials and Supplies and Property, Plant, and Equipment for financial statement purposes. Naval Air Systems Command will review and modify its instructions and internal policies and procedures not later than 90 days following new guidance from the Assistant Secretary’s Financial Management Operations office.

2. Direct NAVAIR personnel to perform a complete reconciliation of the Sponsor Owned Material inventory amounts recorded in the Real-time Reutilization Asset Management System with the actual amounts of inventory at the NAVAIR locations that maintain Sponsor Owned Materials.

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred. The Naval Air Systems Command will perform a complete reconciliation of its Sponsor Owned Material, and develop

and implement policy and procedures for accurate updating of the Virtual Real-time Reutilization Asset Management sponsor owned database. This action is to be completed by July 31, 2007.

3. Require all NAVAIR activities follow DoD Financial Management Regulation, volume 6A, chapter 2, “Financial Reports Roles and Responsibilities,” March 2002. At a minimum, NAVAIR Activities must ensure that audit trails are maintained and demonstrate the accuracy, completeness, and timeliness of a transaction, as well as provide documentary support, if required, for all data generated and submitted to the Defense Finance and Accounting Service for recording in the accounting systems and use in financial reports.

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred. The Naval Air Systems Command is reviewing and will revise Instruction 4451.2 and the “Sponsor Owned Material Customer Review and Inventory Maintenance Procedures.” The new procedures will ensure the accuracy, completeness, timeliness, and documentary support for all data generated by the customer and entered into finance and accounting systems for inclusion in financial reports. The Naval Air Systems Command will also establish appropriate internal controls to assure accuracy of data provided to the Comptroller. The review and modification to instructions and internal policies and procedures will be completed not later than 90 days following new guidance from the Assistant Secretary’s Financial Management Operations office.

4. Strengthen its management control procedures to require that data from subordinate commands that are used in the compilation of Sponsor Owned Material balances are adequately validated prior to their inclusion in the Navy financial statements.

Assistant Secretary of the Navy (Financial Management and Comptroller) Comments. The Assistant Secretary of the Navy (Financial Management and Comptroller) concurred. The Naval Air Systems Command will review and update management control procedures to ensure inventory data received from subordinate commands undergoes quality assurance checks and proper validation. This process will strongly enforce complete accounting oversight of Sponsor Owned Material inventory totals before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in financial statements. Naval Air Systems Command is highly committed to proper accounting and reporting of Sponsor Owned Material. The Naval Air Systems Command has an estimated completion date of July 2007 to complete the review of the management controls.

Appendix A. Scope and Methodology

We performed the audit at the NAVAIR Headquarters in Patuxent River, Maryland, and at NAVAIR SOM storage locations at Port Hueneme, California; Granite City, Illinois; and Jacksonville, Florida, to evaluate the controls over the existence of SOM inventory. We also reviewed DoD, Navy, and NAVAIR policies and regulations regarding responsibilities and procedures for the control over and financial reporting of OM&S. We judgmentally selected 199 items to perform record-to-floor reviews to determine physical existence and record accuracy. We performed this audit from January 2006 through April 2007 in accordance with generally accepted government auditing standards.

Scope Limitation. Initially, NAVAIR personnel could not provide auditable SOM universe information for us to perform the announced audit. We requested NAVAIR provide us with an inventory report for each entity that reports its SOM as of December 31, 2005, the end of the first quarter of FY 2006. We expected the dollar value of each entity's inventory report once summarized would equal what was reported in the Navy's financial statements. However, after several attempts to gain the information, we concluded that NAVAIR was not prepared to provide a universe for its SOM assets that agreed with the amount on the Navy financial statements. NAVAIR personnel agreed with our conclusion and stated that they were unable to recall information for that time. They did provide a database of their current SOM inventory. As such, we selected our sample from the data provided. This limitation did not affect the results of the audit.

Use of Computer-Processed Data. We did not evaluate the general and application controls of the automated systems, although we used data produced by these systems to supplement the audit. We did not evaluate the controls over computer processed data because the objective of this audit was to review controls over the existence of sponsor owned material for financial reporting. Not evaluating the controls over computer processed data did not affect the results of the audit.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the DoD financial management, and supply chain management high-risk area.

Prior Coverage. During the last 5 years, the Naval Audit Service issued one report related to Sponsor Owned Material. The Navy also conducted an audit of NAVAIR Sponsor Owned Material during calendar year 1998 that is pertinent to this audit report. The results of these audits are discussed in the Finding portion of this report.

Naval Audit Service Report No. N2004-0041, "Logistics Feeder Systems Supporting Operating Materials and Supplies Data on the Department of the Navy's Fiscal Year 2002 Financial Statements," April 27, 2004

Naval Audit Service Report No. 037-98, "Management of Sponsor Owned Material at Naval Air Systems Command Warfare Centers," June 2, 1998

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Program Analysis and Evaluation

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Naval Inspector General
Auditor General, Department of the Navy
Commander, Naval Air Systems Command

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Homeland Security and Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Oversight and Government Reform
House Subcommittee on Government Management, Organization, and Procurement,
Committee on Oversight and Government Reform
House Subcommittee on National Security and Foreign Affairs,
Committee on Oversight and Government Reform

Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(FINANCIAL MANAGEMENT AND COMPTROLLER)
1000 NAVY PENTAGON
WASHINGTON DC 20380-1000

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MAR 7 2007 FMO

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING,
DEPARTMENT OF DEFENSE

Subj: DODIG DRAFT AUDIT REPORT ON REPORTING OF NAVY SPONSOR
OWNED MATERIAL STORED AT THE NAVAL AIR SYSTEMS
COMMAND ACTIVITIES (PROJECT NUMBER D2006-D000EJ-0130.001)

Ref: (a) DoDIG memo of 8 Feb 07

Encl: (1) Department of the Navy reponse to DoDIG Draft
Audit Report

By reference (a), you provided subject draft audit report for review and comment. Enclosure (1) contains responses to the findings and recommendations.

My point of contacts for this draft audit are Ms. Beverly Veit at (202) 685-6703 or by email at beverly.veit@navy.mil and Mr. Kyle Fugate at (202) 685-6718 or by email at kyle.fugate@navy.mil


MARK E. EASTON
Director
Office of Financial Operations

**DEPARTMENT OF THE NAVY RESPONSE TO
DODIG DRAFT REPORT ON
REPORTING OF NAVY SPONSOR OWNED MATERIAL STORED
AT THE NAVAL AIR SYSTEMS COMMAND ACTIVITIES
(PROJECT NUMBER D2006-D000FI-0130.001)**

Finding A: Financial Reporting and Controls Over Sponsor Owned Material

NAVAIR incorrectly reported about \$2.5 billion of SOM as OM&S. This included \$1.9 billion of aviation special tooling and test equipment, \$481.6 million of aviation support equipment held for Foreign Military Sales, and \$113.7 million of general aviation support equipment. Those items should have been reported in the Inventory or Property, Plant, and Equipment accounts. Additionally, the Naval Air Systems Command did not adequately validate the data gathered for Sponsor Owned Material before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in the financial statements which led to an overstatement of the inventory by over \$1.5 billion. We also found errors related to inventory control. Our review of 199 judgmentally selected sample items, valued at \$616.4 million, disclosed errors in the quantities on hand on 45 of the items we sampled. The value of the errors totaled \$443.2 million. Additionally, NAVAIR program managers did not always dispose of excess material and some assets were stored improperly. We attributed the conditions to the following control weaknesses:

NAVAIR did not follow existing guidance and properly classify and report its assets in accordance with Federal accounting standards;

NAVAIR personnel did not perform and document annual physical inventories or comply with established policy to require audit trails for the amounts that are reported in its financial statements; and

NAVAIR personnel did not provide adequate oversight of contract work performed to modify the inventory updating and reporting process

As a result of the conditions, the value of Operating Materials and Supplies reported on the Navy Financial Statements for FY 2006 was overstated by at least \$4 billion and the Navy risked undetected loss of items. Unless the Naval Air Systems Command properly reports its Sponsor Owned material and improves its inventory controls, future Navy financial statements will be unreliable and not in compliance with generally accepted accounting principles and the Navy will continue to be at high risk for loss of materials.

NAVAIR Comments: Concur. The implementation of the recommendations below will address these material control weaknesses listed above

Recommendation 1: Commander, NAVAIR enforce Naval Air Systems Command (NAVAIR) Instruction 4451.2, "Management of Naval Air Systems Command Sponsor Owned Material" December 4, 2003, to ensure that the financial reporting of Sponsor Owned Material complies with the Statement of Federal Financial Accounting Standards No. 3 and No. 6. Enforcement should include ensuring proper categorization of material as Operating Materials and Supplies; Inventory; or Property, Plant and Equipment. Any changes should be coordinated with the Assistant Secretary of the Navy (Financial Management and Comptroller).

NAVAIR Comments: Concur NAVAIR will enforce compliance with NAVAIR Instruction 4451.2 upon receiving revised guidance from Assistant Secretary of the Navy (Financial Management and Comptroller) pertaining to the proper segregation of Sponsored Owned Material into categories that comply with the Statement of Federal Financial Accounting Standards No. 3 and No. 6. As stated in DOD Office of Inspector General Report No. D-2007-048, January 26, 2007, "Reporting of Navy Sponsor Owned Material Stored at the Space and Naval Warfare Systems Centers" the Assistant Secretary agreed to "publish updated instructions for the Data Collection Instrument that will properly define the distinction between Operating Materials and Supplies and Property, Plant, and Equipment for financial statement purposes." The Assistant Secretary also agreed to "provide guidance to properly categorize assets." NAVAIR review and modification to instructions and internal policies and procedures will be completed not later than 90 days following new guidance from the Assistant Secretary's Financial Management Operations (FMO).

Recommendation 2: Commander, NAVAIR direct NAVAIR personnel to perform a complete reconciliation of the Sponsor Owned Material inventory amounts recorded in the Real-time Reutilization Asset Management System with the actual amounts of inventory at the NAVAIR locations that maintain Sponsor Owned Materials.

NAVAIR Comments: Concur NAVAIR will perform a complete reconciliation of SOM, and develop and implement policy/procedures for accurate update to the Virtual Real-time Reutilization Asset Management (VRRAM) sponsor owned database. This action will be completed no later than 31 July 2007. A long term mitigation strategy is to develop process and policy procedures for the implementation and sustainment of Enterprise Resource Planning (ERP) software which will replace VRRAM.

Recommendation 3: Commander NAVAIR require all NAVAIR activities follow DoD Financial Management Regulation volume 6A chapter 2 "Financial Reports Roles and Responsibilities," March 2002. At a minimum, NAVAIR Activities must ensure that audit trails are maintained and demonstrate the accuracy, completeness, and timeliness of a transaction, as well as provide documentary support, if required, for all data generated and submitted to the Defense Finance and Accounting Service for recording in the accounting systems and use in financial reports.

NAVAIR Comments: Concur NAVAIR is presently reviewing and will revise NAVAIR Instruction 4451 2, "Management of Naval Air Systems Command Sponsor Owned Material," and the "Sponsor Owned Material Customer Review and Inventory Maintenance Procedures." These new procedures will ensure the accuracy, completeness, timeliness and documentary support for all data generated by the customer and input into finance and accounting systems for input and/or recording in the finance and accounting systems and inclusion in financial reports. NAVAIR will also establish appropriate internal controls to assure accuracy of data provided to Comptroller. The review and modification to instructions and internal policies and procedures will be completed not later than 90 days following new guidance from the Assistant Secretary's Financial Management Operations (FMO)

Recommendation 4: Commander, NAVAIR strengthen its management control procedures to require that data from subordinate commands that are used in the compilation of Sponsor Owned Material balances are adequately validated prior to their inclusion in the Navy financial statements.

NAVAIR Comments: Concur NAVAIR management control procedures will be reviewed and updated to ensure inventory data received from subordinate commands undergoes quality assurance checks and proper validation. This process will strongly enforce complete accounting oversight of Sponsored Owned Material inventory totals before submitting the data to the Assistant Secretary of the Navy (Financial Management and Comptroller) for inclusion in the financial statements. All management control procedures will be in compliance and in accordance with DoD Directive 5000 1, DoD Instruction 5000 2, and DoD Directive 5010 38. NAVAIR is highly committed to proper accounting and reporting of Sponsored Owned Material. The estimated completion date is July 2007

Team Members

The Department of Defense Office of the Deputy Inspector General for Auditing, Defense Financial Auditing Service Directorate prepared this report. Personnel of the Department of Defense Office of Inspector General who contributed to the report are listed below.

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Inspector General Department *of* Defense